

Message Text

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NSC-07 OMB-01 PM-07 RSC-01 SAM-01 SCI-06 SP-03 SS-20

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C O R R E C T E D C O P Y (10TH PARA FROM END TEXT BEGINNING

"AS PRICES ERODE ETC", OMISSION LAST TWO LINES)

EO 11652: GDS

TAGS: ENRG, OECD

SUBJ: US PAPER ON SHORT TERM INTERNATIONAL PETROLEUM OUTLOOK

REF: STATE 70073

1. FOLLOWING IS TEXT OF USG PAPER ON "INTERNATIONAL PETROLEUM OUTLOOK -- SHORT TERM." WE AGREED TO DO THIS PAPER FOR DISCUSSION AT MAY 1 MEETING IN BRUSSELS OF ECG GROUP ON PETROLEUM MARKET OUTLOOK. EMBASSIES IN ECG COUNTRIES ARE REQUESTED TO PASS TEXT TO APPROPRIATE HOST OFFICIAL WITH CAVEAT THAT IT REMAIN CONFIDENTIAL. BEGIN TEXT.

----- THE WORLD OIL MARKET IN 1974

----- CONCLUSIONS

THE PRESENT COMBINATION OF WORLD OIL PRODUCTION AND PRICE LEVELS APPEARS UNSUSTAINABLE. EITHER PRODUCTION OR PRICES MUST FALL SOON.

EVEN BEFORE THE END OF THE EMBARGO, PRICES IN THE WORLD CRUDE OIL MARKET WERE SOFTENING. THE GROWTH OF OIL

DEMAND HAS BEEN CURBED BY SEVERAL FACTORS:

-- THE WORLDWIDE SLOWDOWN IN ECONOMIC GROWTH, WHICH IS EXPECTED TO RANGE 2 PER CENT TO 3 PER CENT.

-- CONSERVATION MEASURES,

-- CONSUMER RESISTANCE TO RISING PRODUCT PRICES,

-- LESS PANIC BUYING AS FEARS OF AN OIL SUPPLY CRISIS SUBSIDE,

-- SUBSTITUTION OF OTHER FUELS FOR OIL.
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WHILE DEMAND HAS BEEN WEAKENING, WORLD OIL PRODUCTION HAS BEEN RISING SLOWLY AND STOCKS OF CRUDE AND PRODUCTS REMAIN AT OR ABOVE NORMAL COMMERCIAL REQUIREMENTS IN ALL MAJOR COUNTRIES.

OUTPUT IS ALREADY RUNNING AHEAD OF CONSUMPTION.
APRIL FREE WORLD SUPPLY NOW AMOUNTS TO SOME 49 MILLION

B/D. APRIL DEMAND IS ABOUT 48 MILLION B/D.

MARKET PROSPECTS FOR THE REST OF THE YEAR DEPEND PRIMARILY ON OPEC PRODUCTION DECISIONS AND THE EXTENT TO WHICH CONSUMPTION GROWS IN THE UNITED STATES. DEMAND IN WESTERN EUROPE AND JAPAN IS RUNNING ABOUT 5 PER CENT BELOW THE LEVELS THAT WOULD HAVE BEEN EXPECTED BEFORE THE PRICE INCREASES. THIS DEGREE OF CONSERVATION SUGGESTS THAT THEIR OIL CONSUMPTION WILL BE ABOUT THE SAME THIS YEAR AS LAST. NO SUBSTANTIAL CHANGE IN CONSUMPTION IS LIKELY IN THE REST OF THE FREE WORLD OUTSIDE THE UNITED STATES, AS CUTBACKS RESULTING FROM BALANCE-OF-PAYMENTS CONSTRAINTS IN SOME COUNTRIES SHOULD AT LEAST OFFSET INCREASED DEMAND IN RAPIDLY GROWING COUNTRIES. TOTAL FREE WORLD DEMAND IN 1974, SHOULD THEREFORE REMAIN CLOSE TO LAST YEAR'S LEVEL OF 49 MILLION B/D. CURRENT PROSPECTS ARE FOR FREE WORLD PRODUCTION ON THE AVERAGE OF ABOUT 51 MILLION B/D.

GIVEN PRESENT SUPPLY AND DEMAND CONDITIONS, THERE SHOULD BE CONSIDERABLE DOWNWARD PRESSURE ON PRICES BY MID YEAR. A DECLINE IN AVERAGE PERSIAN GULF PRICES FROM THE PRESENT LEVEL OF ABOUT \$9.50 PER BARREL TO NEAR THE EQUITY COST OF ABOUT \$7.50 IS NOT UNLIKELY. IF OPEC PRODUCTION CONTINUES TO EXPAND, AND BARRING A MARKED RESURGENCE IN WORLD DEMAND, THE \$7.50 BASE COULD ITSELF BE UNDER SUBSTANTIAL PRESSURE LATER THIS YEAR.

PRESSURES IN THE MARKET ARE ALREADY BECOMING APPARENT. SAUDI OUTPUT HAS RISEN 1 MILLION B/D SINCE FEBRUARY WHILE LIBYA, IRAQ, AND VENEZUELA HAVE CUT OUTPUT. IN THE CASE OF IRAQ AND LIBYA, OUTPUT WAS CUT BECAUSE THE GOVERNMENTS COULD NOT OBTAIN THE PRICES THEY ASKED.
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HOWEVER, IRAQ IS EXPANDING PRODUCTIVE CAPACITY AND WILL HAVE THE ABILITY TO RAISE OUTPUT BY 500 THOUSAND TO 700 THOUSAND B/D IN THE NEXT FEW WEEKS.

-----THE SETTING

BEFORE THE OCTOBER CRISIS, DEMAND FOR OIL WAS OVERTAKING SUPPLY LARGELY BECAUSE OF THE UNPRECEDENTED RATE OF WORLD ECONOMIC GROWTH. PRODUCT PRICES ROSE AND INDUSTRY PROFITS INCREASED RAPIDLY. SMALL CRUDE-SHORT FIRMS WERE SCRAMBLING FOR SUPPLIES. IN AUGUST, WHEN EQUITY OIL COST THE MAJORS \$2.30 A BARREL IN THE PERSIAN GULF, AUCTION OIL WENT FOR \$2.90. THIS PRICE TREND WAS REINFORCED BY GROWING CONCERN OVER A POSSIBLE ENERGY CRUNCH. SAUDI ARABIA WAS HINTING THAT IT, LIKE LIBYA AND KUWAIT,

MIGHT CURTAIL OUTPUT FOR CONSERVATION PURPOSES. ALL OF THESE FACTORS CONTRIBUTED TO THE PSYCHOLOGY OF SCARCITY THAT WAS SO PREVELANT IN THE FALL.

IN MID-OCTOBER,MEETING BACK-TO-BACK IN KUWAIT:

-- THE ARABS ANNOUNCED THEIR DECISION TO CUT PRODUCTION OVER THE NEXT SEVERAL MONTHS.

-- THE PERSIAN GULF OIL PRODUCERS ANNOUNCED A POSTED PRICE INCREASE THAT RAISED THE EQUITY PRICE BY 50 PERCENT, FROM \$2.40 TO \$3.70. OTHER OPEC MEMBERS FOLLOWED WITH SIMILAR INCREASES.

ON 23 DECEMBER, TAKING ADVANTAGE OF THE TIGHT SUPPLY CONDITIONS THAT FOLLOWED THE ARABS' PRODUCTION CUTS, OPEC AGAIN INCREASED POSTED PRICES. THIS UPPED THE PERSIAN GULF EQUITY PRICE BY MORE THAN 100 PER CENT, TO \$7.50, EFFECTIVE ON 1 JANUARY 1974.

IN EARLY JANUARY, THE AVERAGE PRICE OF CRUDE OIL BEGAN TO RISE WELL ABOVE THE EQUITY PRICE. THE INCREASE WAS PARTLY ATTRIBUTABLE TO PANIC BIDDING IN THE AUCTION

-----FOOTNOTE:

FOR CRUDE OIL PRICE DEFINITIONS, SEE THE ANNEX.
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END FOOTNOTE.

OIL MARKET, WHICH QUICKLY FELL OFF AFTER THE ARABS ANNOUNCED AN END TO CONTINUING MONTHLY PRODUCTION CUTS. MORE IMPORTANT, THE COMPANIES RAISED THEIR PRICES IN ANTICIPATION THAT THEY WOULD HAVE TO PAY MUCH MORE FOR BUYBACK OIL THAN THEIR EQUITY OIL COST THEM. BY LATE FEBRUARY, THE PRICE OF PERSIAN GULF CRUDE WAS ON HE ORDER OF \$9.50.

THE CRITICAL ISSUES IN THE MARKET DURING THE REMAINDER OF THE YEAR WILL BE:

-- SAUDI ARABIA'S PRICE AND PRODUCTION DEVELOPMENTS.

-- THE REACTION OF OTHER PRODUCERS TO THESE DEVELOPMENTS.

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